MULTISTATE TAX COMMISSION

Sourcing of Partnership Income

Combined Draft Model Provisions & Recommendations

Discussion Draft – September 15, 2026

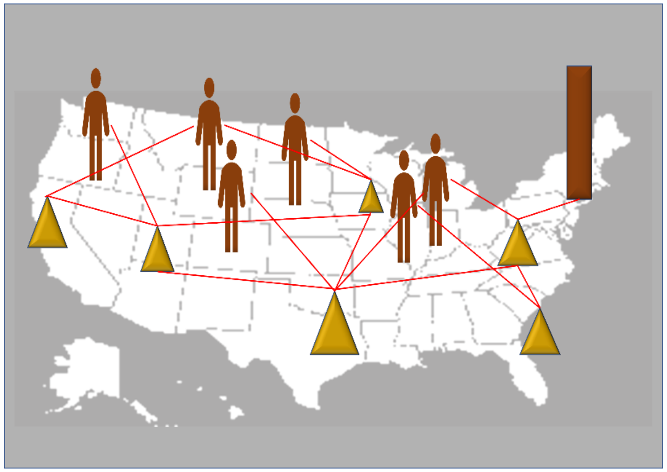
NOTE: This document is a revised version of the discussion draft circulated on April 15, 2026. It contains additional changes in response to comments received. These changes do not alter the general approach recommended in earlier drafts.

The draft model provisions here have:

- **Drafter's notes in blue text as part of the draft provisions.**
- **A number of small edits, including in response to comments, made without highlighting.**
- **Some larger or more substantive changes highlighted in yellow.**
- **A notes section where additional notes about changes are included in green text.**

See also the appendix which summarizes the comments received and the response.

Background on the MTC Partnership Project



This MTC project on taxing partnership income began with a detailed outline of issues. See the latest version, here: **Issue Outline**. The issues fall into several categories including jurisdictional issues, determining the state tax base, sourcing partnership income, etc.

When it comes to sourcing partnership income, the project does not create a new sourcing system of sourcing rules for partnership income. Rather, it aims to clarify how the general state sourcing approaches apply to income taxed under the pass-through system.

The MTC has long worked to bring more uniformity to these general state sourcing approaches. (See our models here: **MTC Models**.)

Sourcing Issues Addressed

So far, the partnership work group has focused on the sourcing of:

- Distributive share income of tiered and corporate partners.
- Guaranteed payments to individuals for services.
- Income of investment partnerships.

For each of these types of income, the work group has produced separate detailed white papers (available on the project page, here: **Partnership Project Page**.

Consistency with Governing Tax Law

These white papers demonstrate that sourcing of partnership income under the pass-through system must be consistent with:

- Subchapter K of the Internal Revenue Code (IRC), to which states conform.
- Common sourcing approaches states have long applied to corporations and nonresidents.
- Sourcing approaches used for partnership withholding, composite, and PTE taxes.

Combining the Draft Provisions

Using recommendations from the white papers, the work group drafted model provisions for each of the issues addressed. The work group also decided that, before finalizing these provisions, they should be reviewed together. This document combines the provisions and adds some information from the white papers.

Changes to this latest version of draft models include revisions as well as notes on the comments received on the prior versions and discussion of these comments by the work group. Prior versions and other materials are on the MTC the project page, here: **Partnership Project Page**.

Challenges in Drafting Model Provisions

Model state tax provisions are almost never "plug-and-play." States that adopt these models must often modify them to fit within their existing statutes and regulations. But these partnership models designed to apply state sourcing rules to partnership income also raise additional challenges:

- The pass-through system is much more complex than entity-level taxation.
- While states generally use similar sourcing approaches, the details vary.
- States may use different terminology for similar partnership or sourcing concepts.
- Existing partnership-specific sourcing rules may be generally worded and lack detailed guidance.
- Partnership rules are typically embedded in individual and corporate tax sections.
- The rules may have developed over time and may not reflect changing precedents.

Despite the challenges, model provisions can still serve as a useful "proof of concept," demonstrating that the general recommendations made in the white papers are workable and highlighting important elements that states should consider. They can also incorporate approaches that states are currently using effectively and can promote uniformity for specific issues.

Key Points – Before Reviewing the Draft Provisions

These points (some of which are discussed in much more detail in the white papers) are important to understand before reviewing the combined draft provisions in the following section:

1 **The provisions apply general state sourcing rules to partnership income.**	As noted above, the project's focus is on applying the states' established income sourcing approaches to the income of partnerships taxed under the pass-through system. This provides equitable treatment for business income regardless of the form of the business
2 **Some unique partnership issues may call for uniform sourcing rules.**	One example of the need for uniformity is the sourcing of guaranteed payments for services—where states take two distinctly different approaches that might lead to duplicative taxation, and which is addressed by draft provisions set out below.
3 **Sourcing on a pass-through basis must be consistent with entity-level taxes.**	Whether taxing partnership income on a pass-through or entity-level basis (withholding, composite, or PTE taxes), the application of sourcing rules should achieve consistent results. Otherwise, inconsistency will lead to different partner-level and partnership-level tax results.
4 **Tax treatment—including sourcing—depends first on the tax character of items.**	The tax treatment of items of income is determined first by the item's tax character. This is also true for sourcing treatment, whether done under federal or state rules. For example, state rules for sourcing non-apportionable income depend on whether that income is from sales of tangible property, intangible property, interest, royalties, etc.
5 **Partnerships determine the tax character of partnership items.**	The tax character of a partnership's items of income that affects their substantive tax treatment is determined at the partnership level. IRC § 702(b). (See also IRS Form 1065 and Schedule K-1.) This includes any tax character derived from specific activities (e.g., business activity, investment, etc.).

6 **The tax character of partnership items is attributed to the partners' shares of those items.**	Attribution is essential to the federal pass-through system. (See IRC § 702.) Attribution requires a partner—whether active or passive, general or limited, direct or indirect—to treat their share of the items recognized by a partnership as if the partner had realized or incurred them directly in the same manner from the same source as the partnership.
7 **Attribution applies for state tax purposes, including when sourcing items.**	States that conform to the federal pass-through system, conform to the attribution principle. So where state sourcing rules depend on the tax character of items—as determined by the activity generating those items—it is the partnership's own activities that matter.
8 **Tax attributes of the partner have a limited effect on sourcing partnership income.**	A partner's own tax attributes do not change the tax character of the partnership items. So, for example, the fact that the partner is not active in the business of the partnership does not change the character of the items. But a partner's attributes may have a limited effect on application of tax rules, including state sourcing rules. Two primary examples are: • Where the partnership and the partner are both engaged in activities that are part of the same unitary business. In that case, states sometimes use "blended" apportionment. • In rare cases where a partner's share of an item determined to be non-apportionable by the partnership is determined by the partner to be part of that partner's separate activities generating apportionable income.
9 **How the unitary business principle applies to partnership income is unclear and the subject of some controversy.**	While some state courts have addressed the application of the unitary business principle and its criteria to the sourcing of partnership income, the U.S. Supreme Court has never done so. It is, therefore, not clear how those criteria apply to partners and partnerships—which have different legal relationships than corporations and shareholders or subsidiaries. For example, some states have recognized that ownership, often used to determine control for corporate entities, does not determine control of partnerships.

10 **Anti-abuse rules and limits are essential to the functioning of the pass-through system.**	The federal pass-through system relies heavily on rules and limitations to prevent abuse. States will need similar rules. But simply conforming to Subchapter K may not be enough. Some federal anti-abuse rules only look to the federal tax result, but partnerships can be used to alter general state tax treatment or shift income without otherwise affecting federal taxes. States should therefore specify that certain rules apply for state tax purposes and provide guidance for their application.
11 **Additional regulations will be needed to implement the statutory provisions here.**	Some of the provisions here are drafted as statutes. States may need to adopt detailed regulations for the application of these rules to partnership income taxed on a pass-through basis. The general provisions set out here are not intended to be a comprehensive package of regulations, but to provide a foundation for those regulations.
12 **As with partnership taxation generally, information reporting is essential.**	While the draft provisions do not address specifically how partnerships will report information, they provide tax agencies with the authority to require necessary information reporting. This level of authority is very similar to the authority Congress has granted to the IRS.

Combined Draft Model Provisions & Recommendations

Prior versions of the draft model provisions for applying state sourcing rules to the income of tiered and corporate partners, guaranteed payments for services paid to individual partners, and for income of investment partnerships are on the project page on the MTC website, here: **Partnership Project Page**.

Formatting Notes:

- Any substantive changes to the most recent drafts are highlighted.
- In addition, certain drafter's notes have been added or clarified.
- Drafter's notes are set out in **blue**.
- References within the draft provisions that depend on that state's own information are shown in brackets and capitalized—[CAPS].
- This version also contains Notes (in the right-hand margin by the provisions) which give additional information and respond to comments received on the draft.

SOURCING OF PARTNERSHIP INCOME BY TIERED & CORPORATE PARTNERS

Drafted in the Form of a Statute

General Drafter's Notes:

Provisions Drafted as Statutes

The provisions in this Section are drafted in the form of statutes designed to provide a sufficient framework so that consistent regulations can be adopted for specific facts and circumstances. Some states may have existing statutory provisions that they view as sufficient—but may consider the provisions here for adoption in the form of general regulations.

Making the Implicit Explicit

States that conform to the federal pass-through system under IRC Subchapter K may believe that certain draft provisions below would apply to their state even if not explicitly stated. Where those concepts are essential, the draft includes them explicitly to avoid confusion or uncertainty.

Inclusion of General Provisions

This Section was initially drafted to address sourcing of partnership income for tiered and corporate partners. However, substantial parts of it also apply generally. Therefore, the scope has expanded to include all partners.

References to State Sourcing Statutes

The draft provisions below include bracketed references for the state sourcing rules for both corporations and nonresidents. Based on the research done as part of the related white paper, most states use the same sourcing methods for sourcing income of businesses, whether for individuals (proprietorships) or corporations. If a state has significant differences in the sourcing rules applied to business income of corporations and individuals, this complicates the sourcing of partnership income whether taxed on a pass-through basis or at the entity level.

STATUTORY SECTION #

SOURCING OF PARTNERSHIP INCOME BY TIERED & CORPORATE PARTNERS

Part I. Definitions of Terms:

Drafter's Note: Terms that are used to refer to partnership tax concepts can vary depending on the body of law—state law governing partnerships, federal tax provisions, or state tax provisions. Differences in terminology can create confusion and uncertainty. These draft provisions set out definitions that states may need to use in their sourcing rules for partnership income. The definitions look to general state law and federal tax law to achieve greater consistency. They may include terms that are not incorporated into the draft provisions below but could be used to the extent those provisions are expanded or for the purpose of drafting related regulations.

A.	Certain terms used in this Section are defined as follows:		
	1.	Allocate or allocation of distributive share of income or items of income – A partnership's determination of a partner's share of partnership income or items of income under the partnership agreement as well as under any applicable state or federal tax law. See IRC § 704.	
	2.	Apportionable income or items – Income or items, including expenses, that are part of net income sourced using an apportionment formula related to that net income. See [REFERENCE(S) TO THE STATE'S STATUTORY PROVISIONS GOVERNING APPORTIONABLE OR "BUSINESS" INCOME].	Re-written to clarify.
	3.	Apportionment formula, factors, and factor components – The formula and factors used to apportion unitary apportionable income and amounts determined, included, and sourced based on the rules in [REFERENCE TO APPLICABLE STATE APPORTIONMENT LAW DETERMINING THE APPORTIONMENT FORMULA].	Added this definition to make clear that the apportionment formula, factors, and factor components (amounts of sales or receipts, property, or payroll) are determined under the adopting state's rules.

4. Attribute (verb) or attribution of income or items – The way in which IRC Subchapter K and the pass-through system for partnerships which it creates assigns partnership items, as determined by the partnership recognizing those items, to any direct or indirect partners who are allocated a share of those items, without altering their tax character. This includes the tax character of these items that may affect the sourcing of the items under [REFERENCE(S) TO THE STATE'S STATUTORY PROVISIONS FOR SOURCING INCOME OTHER THAN APPORTIONABLE INCOME]. See IRC §§ 702(b), 875, 897(c)(4)(B), and 958(a)(2).

Drafter's Note: This provision 3 makes explicit that the tax character of items for state sourcing purposes is determined at the partnership level and attributed to the partners. See further rules under Part IV below.

5. Beneficial interest holder – A person with ownership rights or rights to income in an "other pass-through entity".

This term was added to be used in the model for how income of partnerships flowing from other pass-through entities to those taxed on that income will be sourced.

6. Built-in gain (loss) – The amount of an asset's fair market value as compared to its tax basis at a particular point in time—including the point at which the item is contributed by a partner to a partnership or distributed from a partnership to a partner. See IRC § 704(c).

7. Contribution – Cash or property transferred by a partner to a partnership in exchange for a partnership interest. See IRC § 721.

8. Direct partner – A partner that owns an interest in a partnership directly and not through the partner's ownership in an upper-tier partnership.

9. Distribution – Cash or property transferred by a partnership to a partner that represent, in whole or in part, a return of the partner's capital. See IRC § 731.

10.	Distributive share or distributive share of items or income – The percentage or amount of a partnership's income (loss) or the percentage or amount of particular partnership items allocated to a partner in a given tax period. See IRC § 704.	
11.	Indirect partner – With respect to a particular partnership, a partner that owns an interest in an upper-tier partnership.	
12.	Lower-tier partnership – A reference to a partnership in which another partnership or other pass-through entity holds an interest. See IRC § 706(d)(3).	The terms "other pass-through entity" and "beneficial interest holder" are added to the definitions here and included in the application of the sourcing rules. See further notes with the definitions of those terms below.
13.	Non-apportionable partnership income or partnership items – Partnership income or partnership items that are specifically assigned (or allocated) in whole or in part to [THIS STATE] rather than apportioned. See [REFERENCE(S) TO STATE STATUTORY PROVISIONS FOR DEFINING NON-APPORTIONABLE OR "NONBUSINESS" ITEMS OF INCOME.]	
14.	Other pass-through entity – An entity whose income is taxed on a pass-through basis to its direct or indirect beneficial interest holders under [State] law [SEE REFERENCE TO APPLICABLE STATE LAW WHICH MAY INCLUDE IRC SUBCHAPTER S CORPORATIONS AND CERTAIN TRUSTS].	This term was added to be used in the model for how income of partnerships flowing through such entities will be sourced. The use here does not dictate how other non-partnership income will be treated or sourced.
15.	Partner – A person [REFERENCE TO APPLICABLE STATE DEFINITION OF PERSON IF NECESSARY] treated as a partner for tax purposes under federal tax law, including IRC Subchapter K, which includes direct and indirect partners and members of LLCs. See IRC §§ 761(b) and 7701 and related regulations.	

	16.	<u>Partnership</u> – An entity treated as a partnership under federal tax law, including IRC Subchapter K [WITH ANY EXCEPTIONS FOR STATE TAX PURPOSES], which includes general partnerships, limited partnerships, limited liability companies, etc. See IRC §§ 761(a) and 7701 and related regulations.	
	17.	<u>Partnership agreement</u> – The agreement between the partners generally or on particular partnership matters, regardless of form, as the term is used for federal income tax purposes and consistent with state partnership law [REFERENCE TO THE STATES LAWS FOR GENERAL PARTNERSHIPS, LIMITED PARTNERSHIPS, LLC'S, ETC.]. See IRC §761(c).	
	18.	<u>Partnership income (loss)</u> – A general reference to income (loss) determined and reported by the partnership under IRC Subchapter K. See IRC §703 (and IRS Form 1065).	
	19.	<u>Partnership item</u> – Any tax-significant result generated from a transaction, activity, or event including any item of income, expense, deduction, gain, loss, etc. that is recognized and given particular treatment under federal tax law or the tax laws of this state. See IRC §§ 702 & 704 (and IRS Form 1065, Schedule K-1).	
	20.	<u>Partnership interest or partner's ownership interest</u> – Unless the context otherwise indicates, a partner's legal ownership rights in a partnership or value of the partner's partnership capital. See IRC §§ 704(e) and 864(c)(8).	
	21.	<u>Specifically assign and rules of assignment</u> – The method used to source or allocate income or items of income under [REFERENCE(S) TO STATE STATUTORY PROVISIONS FOR SOURCING NON-APPORTIONABLE OR "NONBUSINESS" ITEMS OF INCOME.]	
	22.	<u>Sufficient unitary relationship</u> – See Part VI.	

23. Tax character of an item – The nature and classification of items for tax purposes which may affect their income tax treatment as determined by a partnership applying general substantive federal or state tax law based on the activity giving rise to the item. See IRC §§ 702(b) and 703(a) as well as [REFERENCE(S) TO STATE RULES CONFORMING OR DECOUPLING FROM FEDERAL TREATMENT AND STATE SOURCING RULES]. The tax character of an item may include:

a. The nature of receipts or expense – such as interest, royalties, dividends, gains (losses), etc.;

b. The type of transaction or activity giving rise to the income or expense – such as sales or purchases of property, leases of property, sales or purchases of services, depreciation of assets, borrowing of funds, etc.; and

c. The assets affected by the transaction or activity – such as real property, tangible or intangible property, inventory, etc.

24. Taxpayer or partner attribute (noun) – An aspect of, or circumstance relating to a particular taxpayer or partner that may affect the ultimate tax result for items recognized by or attributed to that taxpayer or partner, which may include:

a. Whether the taxpayer or partner is a resident or nonresident individual or a corporation or other type of entity;

b. Whether the taxpayer or partner files a separate, joint, or combined/consolidated return;

c. The taxpayer's or partner's marginal effective tax rate; and

d. The taxpayer's participation or role in certain activities.

25. Upper-tier partnership or tiered partner – A partnership that holds an interest in another partnership. See IRC § 706(d)(3).

B. Other terms not defined above are to be interpreted consistently with the context and with [REFERENCE TO LAWS OF THIS STATE] and federal income tax law.

Part II. Conformity to Federal Income Tax Rules, Including IRC Subchapter K

Drafter's Note: As noted above, one challenge for drafting provisions to apply state sourcing rules to partnership income is that states generally have separate sections addressing income taxes imposed on corporations and individuals and may embed partnership-related provisions, including references to sourcing rules and their application, in both sections. While these model provisions are designed to be applicable to tiered and corporate partners (see Part IV.C below), the conformity provisions in this Part II could be used in the context of tax on individuals as well.

A. [STATE] conforms to the federal income tax law, including IRC Subchapter K, as provided in [REFERENCE(S) TO STATE LAWS THAT AFFECT CONFORMITY FOR CORPORATE AND INDIVIDUAL TAXPAYERS]. In conforming to Subchapter K, [STATE] also conforms to the principle that the tax character of items of income and loss is determined at the partnership level and then attributed to the partners who receive a distributive share of those items. This character as determined at the partnership level may affect the state income tax treatment of the items under the state income tax rules, including the sourcing of those items under [REFERENCE(S) TO STATE LAW FOR SOURCING INCOME - INCLUDING CORPORATE AND INDIVIDUAL SOURCING RULES].

B. In addition, [STATE] conforms to certain anti-abuse rules under IRC Subchapter K as described further in Part V of this Section.

Part III. Obligations of Partnerships to File Information Returns and Report Information

Drafter's Note: While the provisions in this Section are designed to be applicable to tiered and corporate partners, the reporting provisions below could be used for individual partners as well, so the reference in C below includes individuals.

			Comment
A.	A partnership shall provide to its direct partners the information necessary for its direct and indirect partners or beneficial interest holders to properly compute and report their [STATE] tax. Necessary information includes any information as described or provided for in regulations, forms, and instructions issued by the [STATE TAX AGENCY]. This requirement to provide information applies to:		This provision was modified to include beneficial interest holders since the approach described here could be applied to the lower-tier partnership income flowing through these entities.
	1.	Any partnership doing business in [STATE];	
	2.	Any partnership that has a direct partner or an indirect partner or beneficial interest holder doing business in or resident in [STATE].	This provision was modified to include beneficial interest holders since the approach described here could be applied to the lower-tier partnership income flowing through these entities.
	3.	Any partnership that has a direct or indirect interest in a partnership or other pass-through entity doing business in [STATE].	This section was modified to include other pass-through entities since the approach described here could be applied to the lower-tier partnership income flowing through these entities
B.	A partnership shall provide to the [STATE TAX AGENCY] certain information as directed by the [STATE TAX AGENCY] necessary to verify the information required to be reported to partners under Subpart A, above and as provided in regulations, forms, and instructions issued by the [STATE TAX AGENCY].		
C.	The type of information that may be required to be reported to partners or to [STATE TAX AGENCY] under this Part II includes:		
	1.	Federal tax-related information, including the tax character of partnership income and items recognized by the partnership or allocated to the partnership from lower-tier partnerships;	

	2.	State tax-related information, including the tax character of partnership income and items recognized by the partnership or allocated to the partnership from lower-tier partnerships, as relevant to compliance with [REFERENCE TO STATE INCOME TAX RULES FOR CORPORATIONS AND INDIVIDUALS];	
	3.	Information necessary for direct or indirect partners to properly determine the source of partnership income and items, as described further in this Section;	
	4.	Information from lower-tier partnerships or business entities in which the partnership holds an interest that is necessary for that partnership's direct or indirect partners to properly determine the source of partnership income and items as described further in this Section; and	
	5.	Any other information the partnership may have or obtain that is necessary for direct or indirect partners to properly report their state tax on partnership income and items.	
D.	To the beneficial interest holders of another pass-through entity are taxed on partnership income flowing through that entity, the entity may also be required to report information described in this Part III.		This Subpart D was added to address the need for information flowing through other pass-through entities.
E.	A partnership or other pass-through entity is presumed to have knowledge that an indirect partner or beneficial interest holder is doing business or resident in this state for purposes of this Part III if that information is otherwise known to that partnership or if the partnership has received a notification from a partner, indirect partner, or beneficial interest holder. If, under the circumstances, a partnership or other pass-through entity is not presumed to have this knowledge, the failure to provide information to its partners that is necessary for indirect partners or beneficial interest holders to properly compute and report their [STATE] tax will not be subject to any penalties.		This Subpart E was added to address comments noting that a lower-tier partnership may not have information on its indirect partners. Because this information reporting process is essential for the working of the pass-through system, partnership structures cannot be used to avoid those or other legal requirements—particularly where the partnership otherwise has knowledge or has been notified. But where this is not the case, no penalties for failure to report would be imposed on the entity.

Part IV. Sourcing of Partnership Income and Items

Drafter's Note: These provisions are designed to for tiered and corporate partners and to address the use of blending. But the approach described in Subparts A and B is consistent with state sourcing of income of individual partners as well. Therefore, this Part IV also includes provisions for sourcing income where blending is not used, including for individual partners.

And while the rules below provide references to both a state's corporate and individual state tax and sourcing rules, this is because those rules are often contained in separate sections of state law. But we assume that the rules would generally be the same whether sourcing the income from business activities of individuals or corporations. If this is not the case for a particular state, it will complicate the application of both the pass-through tax system and any entity-level taxes applied to partnerships.

Finally, to the extent a state has adopted Section 18 authority, that authority may also apply to partnership income, subject to the specific language and requirements of the state's provision.

A.	In applying the sourcing rules below, a partnership required to report information as described in Part III, must properly apply the applicable [STATE] and federal tax rules as required by Part II in determining that information.	
B.	Items Recognized Directly by a Partnership:	
	Drafter's Note: Partnership structures may include multiple tiers, partners that are other partnerships or other pass-through entities, through which a lower-tier partnership's distributive share income and items pass before being allocated by the upper-tier entities to taxpaying partners or beneficial interest holders. Under IRC Subchapter K, an item's character is determined by the partnership recognizing the item and does not change. *Paragraph B is intended to make explicit the requirement that the partnership first recognizing the item of income, expense, gain, or loss must also determine its tax character for state tax treatment, including sourcing.*	This Subpart B was clarified and also now includes references to other pass-through entities.

Application of the rules for sourcing income under [REFERENCE TO STATE'S SOURCING RULES FOR INCOME OF BUSINESS ENTITIES, CORPORATIONS, OR NONRESIDENTS] to partnership income and items requires that a partnership determine the following with respect to the items of income, expense, gain, loss or other tax items that it recognizes directly from its activities and to guaranteed payments made to partners:

> This is to clarify that guaranteed payments—that is, payments to partners acting as partners in the partnership but not dependent on income (see IRC § 707(c)) will generally be subject to the same sourcing rules as other partnership items. It appears that guaranteed payments will generally be apportionable to the partnership. (See below.)

1. Information as to the general tax character of those partnership items as it may be relevant to state tax treatment of the items, including:
   a. The tax character of the items for purposes of determining their federal tax treatment to which the state conforms;
   b. The tax character of the items for purposes of determining their state tax treatment, including any treatment that varies from the federal tax treatment; and
   c. The tax character of the items for purposes of applying the sourcing rules in [REFERENCE TO STATE'S SOURCING RULES FOR INCOME OF BUSINESS ENTITIES, CORPORATIONS, OR NONRESIDENTS].
2. Information as to whether any partnerships items are non-apportionable as that term is defined by this Section and the rules provided in [REFERENCES TO STATE'S SOURCING RULES—TREATMENT OF NON-APPORTIONABLE OR NONBUSINESS ITEMS FOR CORPORATIONS OR NONRESIDENTS] applying those rules based on:
   a. The item's particular tax character as determined by the partnership; and
   b. The relationship of the item to the business activity conducted by the partnership, alone or in conjunction with the activity conducted by one or more entities in which the partnership holds a direct or indirect interest.

		In determining this information, the partnership must also determine whether its items of income have a sufficient unitary relationship to any business in which the partnership participates that also generates apportionable income, with the understanding that a partnership may engage in more than one unitary business.	
	3.	Information necessary for sourcing all non-apportionable items determined under Paragraph 2 under [REFERENCE TO STATE'S SOURCING RULES—TREATMENT OF NON-APPORTIONABLE OR NONBUSINESS ITEMS FOR CORPORATIONS OR NONRESIDENTS].	
	4.	Information on the apportionable income of the partnership as determined under [REFERENCE TO STATE'S SOURCING RULES—TREATMENT OF APPORTIONABLE OR BUSINESS ITEMS FOR CORPORATIONS OR NONRESIDENTS] based on the particular business activities to which the items making up that net apportionable income have a sufficient unitary relationship, including business activity conducted by one or more entities in which the partnership holds a direct or indirect interest, with the understanding that a partnership may engage in more than one unitary business. Guaranteed payments to partners for services are presumed to be part of the partnership's apportionable income.	Guaranteed payments to partners acting as partners (for services or capital) are presumed to be apportionable items (expense) to the partnership given that the payments are made to partners acting as partners (IRC § 707(c)), rather than in another capacity (IRC § 707(a)), and involve providing items that would be considered essential to the partnership's business.
	5.	Information on the partnership's apportionment factor attributes related to the items determined to be part of apportionable income under Paragraph 4, applying [REFERENCE TO STATE'S SOURCING RULES—APPORTIONMENT FACTORS] to enable determination of those apportionment factors.	

C.	Upper-Tier Partnership and Other Pass-Through Entity Treatment of Items Allocated from Lower-Tier Partnerships:	This section was modified to include other pass-through entities since the approach described here could be applied to the lower-tier partnership income flowing through these entities.
	Drafter's Note: As discussed at length in the related white paper, a majority of states use blended apportionment to source partnership income for tiered and corporate partners. Of those that specify how the share of partnership apportionment factors to include in the partner's formula will be determined, most refer to the use of a ratio based on the partner's distributive share of profit and loss. *This approach is conceptually preferable to other possible approaches for a number of reasons, but raises an issue when the partnership makes dis-proportionate special allocations of items, guaranteed payments, or mandatory or remedial allocations to tiered or corporate partners. In some cases, the partner's distributive share will be negative whereas the partnership's total distributive share income including guaranteed payments is positive, or vice versa. But even when this is not the case, the share of the partnership's apportionment factors will be affected if the partner that uses blending receives relatively higher or lower shares of any expense/loss items versus income/gain items or has significant guaranteed payments.* *The work group has therefore discussed the use of the absolute value method and has published different examples (in Excel workbooks) demonstrating the application of that method. This absolute value method is necessary to ensure that the partner who blends the partnership's apportionment factors with its own includes a share of those factors that represents the effect on that partner's income of its share of the partnership items—whether that effect is positive or negative.* *Note that the absolute value method is used as the default rule. However, when all the items of income and deductions composing the distributive shares of all partners are allocated in the same proportion for each partner, and there are no guaranteed payments or notional allocations, the absolute value method yields the same result as if it was not used.*	This drafter's note was expanded to make clear that the problem in using a partner's ratio of distributive share to determine the partner's share of partnership factors does not arise where there are special allocations alone but from where those allocations are disproportionate or where partners receive guaranteed payments. So, for example, if two partners who hold equal capital interests in a partnership agree to share all partnership income (loss) items 60/40, rather than 50/50, the share of factors will be the same whether using distributive share with or without the absolute value method. But if the partners instead agree to share capital losses 60/40 while sharing other items 50/50, then this is a disproportionate special allocation and there will be a different result depending on whether the absolute value is used.

Guaranteed payments and items of income, expense, gain, loss or other tax items that are allocated to an upper-tier partnership or other pass-through entity by a lower-tier partnership retain their tax character as determined in Subpart B regardless of whether the allocations are made in accordance with the partner's partnership interest, or are special, mandatory, or remedial allocations. But the upper-tier partnership or other pass-through entity will also determine the following with respect to these guaranteed payments and allocated items when reporting information to that upper-tier partnership's partners or the entity's beneficial interest holders:	See the note for Subpart C above. Also, guaranteed payments are included in this Subpart and the provisions have been reworded somewhat for clarity.
1. Whether guaranteed payments or items determined by the lower-tier partnership to be non-apportionable under Subpart B.2, or apportionable under Subpart B.4, have a sufficient unitary relationship to any business activity generating apportionable income in which the upper-tier partnership or other pass-through entity is engaged directly or in conjunction with any entity in which the partnership owns a direct or indirect interest.	
2. If any guaranteed payments or items determined to be non-apportionable by the lower-tier partnership are properly determined by the upper-tier partnership or other pass-through entity to have a sufficient unitary relationship to that partnership's or entity's own business activity generating apportionable income, then the upper-tier partnership or other pass-through entity will include these guaranteed payments and items in the apportionable income from that partnership's or entity's related business activities to be apportioned using the upper-tier partnership's or other pass-through entity's apportionment factors.	
3. If any guaranteed payments or items determined to be apportionable by the lower-tier partnership are properly determined to have a sufficient unitary relationship to the upper-tier partnership's or other pass-through entity's business activity generating apportionable	See the note for Subpart C above. Other changes were made to clarify the application of blending.

	income, the upper-tier partnership or other pass-through entity will include these guaranteed payments and items in the apportionable income from that partnership's or entity's related business activity. When sourcing this unitary apportionable income, the upper-tier partnership or other pass-through entity will include a share of the lower-tier partnership's apportionment factors from the related unitary business activity in the upper-tier partnership's or other pass-through entity's apportionment factors, aggregating the factor components. This inclusion of a share of lower-tier partnership factors with the partner's own factors will be referred to as the blending of apportionment factors. Under this calculation, the corporate partner adds its share of the partnership's factor components to its own factor components, and the corporate partner's apportionment factors are recalculated based on the resulting aggregations.	
3.	The share of the lower-tier partnership's apportionment factors to be included when blending apportionment factors under Paragraph 2 of this subpart is determined using a ratio which is the partner's total unitary guaranteed payments and distributive shares of items computed using the absolute value of those items, divided by the total of all the unitary guaranteed payments and distributive shares of items to all partners of the lower-tier partnership computed using the absolute value of those items. In determining the blended receipts factor, any receipts representing transactions between the partner and partnership will be eliminated from that blended factor to the extent of the partner's distributive share of the partnership items (receipts or expenses) associated with those transactions.	The provision now includes a specific reference to how guaranteed payments will go into the calculation of the ratio to determine the partner's share of partnership factors. Also, the drafter's note that was included here—stating that states might adopt the absolute value method only for partnerships making special allocations—was removed. It caused confusion as to whether not using that method would reach a different result in those circumstances. (It will not.) And, as the drafter's note for this Subpart C above explains, the result will also be the same where there are no guaranteed payments and the special allocations are not disproportionate. The provision now includes a specific reference to how guaranteed payments will be treated in the calculation of the blended factors.

	4.	If any guaranteed payments or items allocated to the upper-tier partnership or other pass-through entity by the lower-tier partnership are properly determined not to have a sufficient unitary relationship to the upper-tier partnership's or other pass-through entity's business activity generating apportionable income, the upper-tier partnership or other pass-through entity will source these guaranteed payments or items as stated in the information from the lower-tier partnership as provided by Subpart B.	This Paragraph 4 is added to make clear that the default method is to source partnership items at the partnership level, retaining that sourcing as items are allocated to and reported by partners or beneficial interest holders of an upper-tier partnership or other pass-through entity.
	5.	Upper-tier partnerships and other pass-through entities must provide sufficient sourcing information for their partners or beneficial interest holders to properly source their guaranteed payments or distributive share income in accordance with these provisions.	This Paragraph 5 is added to make clear that the tiered partnership or other pass-through entity is required to report information to its partners or beneficial interest holders in accordance with these rules.
D.	Corporate Partner Treatment of Items from Partnerships:		
	See the Drafter's Note for Subpart C above.		
	Guaranteed payments and items of income, expense, gain, loss or other tax items that are allocated to a corporate partner retain their tax character as determined in Subparts B and C regardless if the allocations are made in accordance with the partner's partnership interest, or are special, mandatory, or remedial allocations. But the corporate partner will also determine the following with respect to these guaranteed payments and allocated items:		See the notes for Subpart C above.
	1.	Whether guaranteed payments or items determined by the partnership to be non-apportionable under Subparts B.2 or C.2 or apportionable under Subparts B.4 or C.3 of this Part IV have a sufficient unitary relationship to any business activity generating apportionable income in which the corporate partner is engaged directly or through related entities.	

2.	If any guaranteed payments or items determined to be non-apportionable by the partnership have a sufficient unitary relationship with business activity of the corporate partner generating apportionable income, the corporate partner will include these items in the apportionable income from that corporate partner's related business activity to be apportioned using the corporate partner's apportionment factors.	
3.	If any guaranteed payments or items determined to be apportionable by the partnership have a sufficient unitary relationship with the business activity generating apportionable income of the corporate partner, the corporate partner will include these items in the apportionable income from that corporate partner's related business activity. In addition, the corporate partner and will include the related share of the partnership's apportionment factors in the corporate partner's apportionment factors. This inclusion of a share of partnership factors with the partner's own factors will be referred to as the blending of apportionment factors. Under this calculation, the corporate partner adds its share of the partnership's factor components to its own factor components, and the corporate partner's apportionment factors are recalculated based on the resulting aggregations.	
4.	The share of the partnership's apportionment factors to be included when blending apportionment factors under Paragraph 3 of this subpart is determined using a ratio which is the partner's total unitary guaranteed payments and distributive shares of items computed using the absolute value of those items divided by the total of all the unitary guaranteed payments and distributive shares of items to all partners of the lower-tier partnership computed using the absolute value of those items.	The provision now includes a specific reference to how guaranteed payments will go into the calculation of the ratio to determine the partner's share of partnership factors. Also, the drafter's note that was included here—stating that states might adopt the absolute value method only for partnerships making special allocations—was removed as it caused confusion.

		In determining the blended receipts factor, any receipts representing transactions between the partner and partnership will be eliminated from that blended factor to the extent of the partner's distributive share of the items (receipts or expenses) associated with those transactions.	
	5.	If guaranteed payments or items allocated to the corporate partner are properly determined not to have a sufficient unitary relationship to the partner's business activity generating apportionable income, the corporate partner will source these items as stated in information from the lower-tier partnership as provided by Subpart B.	This Paragraph 6 is added to make clear that the default method is to source partnership items at the partnership level, retaining that sourcing as items are allocated to and reported by corporate partners.
E.	All Other Partners Treatment of Items from Partnerships		New provision.
	Items allocated to other partners will be sourced using information from the partnership as provided in Subpart B, unless other provisions of [STATE] law provide for different sourcing treatment.		This ties the provisions here to the treatment of partnership income for partners other than tiered-partnerships, other pass-through entities, or corporations. This may include individuals and proprietorships or taxable trusts. States will need to separately provide information on how the partnership income received by these taxpayers, especially proprietorships or trusts otherwise engaged in business, will be treated.

Part V. Application of Federal Tax Requirements, Limitations, and Anti-Abuse Rules

Drafter's Note: These provisions should also be considered for adoption in taxing individual partners as well as for tiered and corporate partners. Note that these types of anti-abuse rules as used in the federal tax system are often accompanied by lengthy regulations explaining their application in different circumstances. A few states have also adopted more detailed rules focusing on how these anti-abuse provisions apply in the state tax context, especially where state sourcing rules are affected even if federal tax is not. (See the related white paper and sections discussing anti-abuse rules as well as the rules that New York has adopted.)

A.	Rules Setting Specific Requirements or Limitations: Various federal tax rules apply to determine the proper tax treatment of partnership income under the Internal Revenue Code. See, generally, Subchapter K, and the related federal regulations. To the extent these rules set specific requirements for or limitations on certain treatment of partnership items for federal tax purposes, those requirements or limitations also apply to any directly related state tax effects.		
B.	Rules Based on Economic Effect or Substance: Other federal tax rules provide that the results of the federal tax treatment claimed must be consistent with the economic effect or substance of the activities or transactions undertaken or purported to be undertaken. Where the tax results are not consistent with the economic effect or substance, these rules may require modification of the tax treatment. To the extent these rules limit certain treatment of partnership items for federal tax purposes, they also limit any directly related state tax effects. In addition, these rules may also be applied in determining the proper treatment of partnership income where the effect is solely on the state tax result, including the application of sourcing rules under [REFERENCE TO STATE SOURCING RULES]. In applying these federal requirements to the state tax treatment of partnership income, the inquiry will not be limited to the effect on federal taxes or the tax result but will also consider whether the state tax results fairly represent the economic effect or substance of the activities or transactions. In particular, the following federal requirements will be applied when determining the proper state tax treatment, including the sourcing of partnership income:		
	1.	The general federal tax economic substance rule set out in IRC § 7701(o);	
	2.	The general partnership anti-abuse rule set out in IRS Reg. § 1.701-2;	

	3.	The substantial economic effect requirements under IRC § 704(b) and related regulations;	
	4.	The rule for determining the effects of related-party transactions under IRC § 482;	
	5.	The consistency requirement of IRC § 6222.	
C.	In the case of mandatory allocations of built-in gains (losses) to the contributing partner as required under Subchapter K, the source of those gains (losses) will be determined under the rules of Part V of this Section unless there is evidence that the property was contributed by the partner to the partnership in order to shift the sourcing of that gain (loss).		

Part VI. Sufficient Unitary Relationship

[Drafter's Note: The "unitary business" principle is a concept created by the U.S. Supreme Court to limit how states may assert the power to tax a portion of multistate income—in particular where formulary apportionment is used to apportion net income. Since its creation, the Court has applied this principle in less than 30 cases, all of which involve taxable entities or businesses (generally corporations). To date, the Supreme Court has never applied the principle in the context of partnership taxation under the pass-through system where the income of the partnership is attributed to its partners.

Because the unitary business principle is a judicial creation, states have limited authority to issue binding regulations—and its application may be dependent upon specific facts and circumstances. As a result, states may have less in the way of specific statutory or regulatory provisions addressing the application of the principle than they would for other tax provisions, relying instead on litigation to address uncertain cases.

Nevertheless, it appears that there may be circumstances in which the application of apportionment to partnership income will require taking into account the activities and factors of partnerships and their partners in order to achieve fair apportionment. And since partnership structures are very flexible and can change from year to year, states that look only to the activities of a single entity may find that the sourcing of income can be easily shifted.

To address this, states can provide for "blended apportionment" as provided in Part IV.(C) and (D) above. In order to do this, states will have to consider the application of the unitary business principle in this context. States may also want to consider other limitations on the use of blended apportionment, such as limits related to the amount of a partner's distributive share.]

The term "sufficient unitary relationship" as used in this section refers to the necessary relationship between items of income and the apportionment factors used to source that income, especially in the pass-through tax system used to impose tax on partners for their shares of partnership income. The term takes into account all the facts and circumstances relevant to the sourcing treatment of particular items of income including:

A. The relationship between the partnership that recognizes the income or items and the partners, including tiered partners, or other entities that are engaged in the related business activities generating other income or items, including:

1. The extent of actual common control, direct or indirect, held or exercised over the business activities, regardless of the share of partnership capital held;
2. The extent to which related activities are integrated or coordinated;
3. The extent to which resources and costs are shared; and
4. The extent of transactions or flows of value between the entities.

B. The extent of common use by the partnership and partners, including tiered partners, of assets held by the partnership or partners.

C. The nature of common use by the partnership and partners, including tiered partners, of assets held by the partnership or partners.

SOURCING OF GUARANTEED PAYMENTS FOR SERVICES AND ADDITIONAL CREDIT FOR TAXES PAID TO OTHER STATES

Drafted in the Form of Statutes and Regulations

General Drafter's Note:

The draft provisions below include: (1) a general statute for sourcing and taxing guaranteed payments for services; (2) regulations implementing that general statute; and (3) a statute providing an additional credit for taxes paid to other states.

Federal tax rules generally source guaranteed payments for services to the location where the partner performs the services. See IRC § 911. But the majority of states that specifically address this issue do not follow this approach and instead require partners to source the guaranteed payments in the same manner as distributive share.

SOURCING STATUTORY SECTION #

Part I. State Sourcing and Taxation of Certain Guaranteed Payments

A. General Rule

Drafter's Note: The general rule here provides that guaranteed payments for services will be sourced by the state in the same way as distributive share.

Also note that this provision is for taxes applied to income of entities on a pass-through basis. Comments on this provision noted that some states may not have addressed the potential double-counting of guaranteed payments that may result where there is an entity-level tax so that the payments are included in the partnership's apportionable business income and again as separately sourced income to the partner.

Guaranteed payments recognized under Section 707(c) of the Internal Revenue Code by a direct, nonresident individual partner for the performance of services are sourced to this state as provided in

	[REFERENCE TO SECTION OF STATE LAW THAT GOVERNS THE SOURCING OF PARTNERSHIP DISTRIBUTIVE SHARE USING GENERAL ALLOCATION AND APPORTIONMENT RULES APPLIED AT THE PARTNERSHIP LEVEL.].	
B.	Guaranteed Payments Made to a Retired Partner	
	Drafter's Note: Under federal pension law, certain guaranteed payments to retired partners can only be sourced to their state of residence. Subsection (B) satisfies this requirement by sourcing such payments made to nonresidents outside of the state.	
	Guaranteed payments made to a retired nonresident partner are sourced outside of this state provided the payment is "retirement income" as defined in 4 U.S.C. § 114(b)(1)(I).	
C.	Guaranteed Payments Made to Foreign Partners and Domestic Partners Performing Services Overseas	
	Drafter's Note: This decouples the state from the federal sourcing rules for guaranteed payments for services. Note that state statutes that conform the state's law to federal taxable income or adjusted gross income may also need to be amended.	
	Notwithstanding any provision of federal law, including IRC § 911, guaranteed payments made to foreign partners and to domestic partners performing services in a foreign country are sourced using the general rule of subsection (a).	

SOURCING REGULATORY PROVISIONS

Sourcing of Certain Guaranteed Payments

Drafter's Note: The purpose of this regulation is to provide guidance on the imposition of state income tax on certain guaranteed payments for services and the sourcing of those payments.

Examples:

In examples 1 - 5, assume the following:

- Partnership X has a 20% apportionment factor in this state.
- Partnership X's Federal 1065 shows $150,000 of gross receipts and $50,000 of guaranteed payments and no other income or deductions.
- Smith is a nonresident partner that holds a 10% interest in Partnership X.
- Jones is a nonresident partner that holds a 90% interest in Partnership X.
- The Partnership X agreement provides that Smith will receive the $50,000 in guaranteed payments and Smith and Jones will be allocated distributive share items according to their respective interests in the partnership.
- Neither Smith nor Jones has other income in this state.

Simple Example 1:

Partnership X will have $100,000 ($150,000 gross receipts - $50,000 guaranteed payment) of ordinary business income that it will pass through to Jones and Smith. As a result, Smith's distributive share of partnership ordinary business income will be $10,000, and Jones' distributive share will be $90,000. Partnership X's apportionment factors will apply to the distributive shares so Smith will have an apportioned distributive share of $2,000 in this state and Jones will have an apportioned distributive share of $18,000 in this state.

	Pursuant to subsection (b), Smith will also apportion 20% of her guaranteed payment ($10,000) to this state. As a result, Smith's taxable income in this state will be $12,000.	
	Example 2: Assume also that Smith is a retired partner, and the guaranteed payment meets the requirements of "retirement income" as defined in 4 U.S.C. § 114(b)(1)(I). In this scenario, subsection (c) provides that the entire guaranteed payment will be sourced outside of this state. Other items of distributive share will be sourced according to [REFERENCE TO MODEL STATUTORY PROVISIONS ABOVE]. As a result, Smith and Jones will have $2,000 and $18,000, respectively, of apportioned distributive share income in this state.	
	Example 3: Assume Smith receives the guaranteed payment for services performed outside of the United States. Under [REFERENCE TO THE MODEL ACT, SUBSECTION (C)], guaranteed payments made to foreign partners are sourced the same as guaranteed payments made to domestic nonresident partners. Therefore, the result will be the same as in example 1, above.	
In examples 4 and 5, assume the following: • Partnership X has offices and activities in this state. • Partnership X has a 20% apportionment factor in this state. • Partnership X's Federal 1065 shows $40,000 of gross receipts and no other income. • Partnership X's Federal 1065 shows a $50,000 guaranteed payment and no other deductions. • Smith is a nonresident partner that holds a 10% interest in Partnership X.		

- Jones is a nonresident partner that holds a 90% interest in Partnership X.
- The Partnership X agreement provides that Smith and Jones will allocate distributive share items according to their respective interests in the partnership.
- Neither Smith nor Jones has other income.

Simple Example 4:

Partnership X will have $10,000 of ordinary business loss ($40,000 gross receipts - $50,000 guaranteed payment). Smith and Jones will have $1,000 and $9,000, respectively of distributive share of this ordinary business loss. Partnership X's apportionment factors will apply to the distributive shares so Smith will have an apportioned distributive share loss of $200 in this state and Jones will have an apportioned distributive share loss of $1,800 in this state.

Pursuant to subsection (b), Smith will also apportion 20% of her guaranteed payment to this state. So, her apportioned guaranteed payment will be $10,000, which gives Smith total apportioned income in this state of $9,800.

Example 5: Smith is a retired partner, and the guaranteed payment meets the requirements of "retirement income" as defined in 4 U.S.C. § 114(b)(1)(I).

In this scenario, subsection (c) provides that the entire guaranteed payment will be sourced outside of this state. Other items of distributive share will be sourced according to [REFERENCE TO STATE SOURCING STATUTES AND RULES APPLICABLE TO DISTRIBUTIVE SHARE ITEMS]. As a result, Smith will have $200 of apportioned distributive share loss in this state and Jones will have an apportioned distributive share loss of $1,800 in this state.

CREDIT STATUTORY SECTION

Drafter's Note: The additional credit below recognizes that a minority of states source guaranteed payments for services based on the location of the performance of the service. This credit is drafted as a statute to be adopted by residency states that source guaranteed payments in the same way as distributive share, and may wish to provide their residents with a credit if they would otherwise pay tax on the guaranteed payment sourced to the location of performance.

Part I. Additional Credit for Taxes Paid to Other States on Certain Guaranteed Payments

Drafter's Note – It may be that states already have a credit equivalent to this provision.

A. Additional Credit for Taxes Paid to Other States on Certain Guaranteed Payments

A resident in this state that receives a guaranteed payment for services under IRC § 707(c) performed for a partnership in which that resident owns a direct interest and where the services are performed in another state which imposes an income tax on the guaranteed payment based on the location of the service performed may claim an additional credit against the tax owed in this state, computed by multiplying the allowable effective tax rate times the allowable guaranteed payment.

B. Definitions

For purposes of this credit:

1. The allowable effective tax rate equals the lesser of:

   a. The amount of the resident's tax on total net income properly reported in this state before the credit provided by this section divided by the amount of that total net income; or

b. The amount of the resident’s tax paid on total net income properly reported in the other state, including any tax paid by the partnership on the resident’s behalf, divided by the amount of that total net income.

2. The allowable guaranteed payment equals the lesser of:

a. The amount of the partner’s guaranteed payment properly reported as taxable to the other state; or

b. The amount that results from subtracting the partner’s distributive share of any related partnership net loss from the partner’s total guaranteed payment for services [SUBJECT TO OTHER LIMITS THE STATE MAY IMPOSE], multiplied by the ratio of the number of partner working days spent in the state divided by the total partner working days in the tax year, where:

i. The partner’s distributive share of any related partnership net loss is equal to the amount of the partner’s distributive share of expense and loss in excess of the partner’s distributive share of income and gain from the partnership that is allocated to the partner and properly reported in this state;

ii. Partner working days are the total days during the tax year in which the partner performed services for the partnership; and

iii. Partner working days spent in the state equals total days during which the time the partner spent performing services in that state exceeds the time spent working in any other state.

STATE TAX TREATMENT OF INVESTMENT PARTNERSHIPS

Drafted in the Form of Regulations

General Drafter's Note:

While states typically look to the activities of the partnership when sourcing the partnership's income, the majority of states provide that the partnership's activities (including its in-state property and payroll) will not determine the sourcing of income that is primarily from investment activities.

The model's approach to this exception is limited to those partners who are nonresident individuals (or taxed as nonresident individuals) and sources income as if the nonresident partner held the corresponding assets directly. In addition, the following requirements apply:

- *The partner does not engage in managing the investment partnership.*
- *The partner is not a dealer in investments.*
- *The investment partnership interest is not held as part of the business of the partner.*
- *The partnership is not unitary with any other business.*

SOURCING REGULATION PROVISIONS:

Sourcing of Investment Partnership Income

(a) General Rule

Under the [REFERENCE TO STATE'S INDIVIDUAL INCOME TAX], a nonresident partner's distributive share of partnership income is generally allocated and apportioned to this state at the partnership level based on the partnership's business or other activities in this state. See [INSERT REFERENCE TO APPLICABLE STATUTES AND REGULATIONS, INCLUDING UDITPA IF APPLICABLE, AND TO IRC § 702]. But the investment related activities of a qualified investment partnership in this state do not affect how certain nonresident partners source their distributive share of that partnership's investment income. Rather, the sourcing rules for nonresidents apply to the items of income making up the partner's distributive share from the qualified investment partnership as though the partner earned (or incurred) the items directly. See [REFERENCE TO APPLICABLE STATUTES AND REGULATIONS GOVERNING SOURCING OF INCOME FOR NONRESIDENTS].

(b) Applicability to Certain Nonresident Partners

This rule, which provides that the investment related activities of a qualified investment partnership in this state will not affect the sourcing of distributive share income from that partnership, applies to the partners of the qualified investment partnership who are nonresident individuals [AND TRUSTS AND/OR ESTATES, IF APPLICABLE], and therefore pay tax on a source basis to the state, and who do not actively engage in the management of the qualified investment partnership, including recruiting investors, overseeing investments, performing administrative functions, and similar activities.

(c) "Qualified Investment Partnership"

A qualified investment partnership, as used in this regulation, means a partnership that:

(1) does not act as a dealer under 26 U.S.C. § 475(c);

(2) does not act as a financial institution as defined by [REFERENCE TO STATE LAW]; and

(3) holds assets solely for investment purposes and:

(i) does not materially participate or otherwise actively engage in the activities of the businesses in which it holds interests;

(ii) is not unitary with a business in which it holds interests; and

(iii) does not use or employ assets in any way other than for investment.

DRAFTER'S NOTE – The term "materially participate" is a term used under federal tax law, IRC § 469, to limit the ability to offset expenses/losses against income/gains in certain circumstances. The term "actively engage" allows states to expand on this concept where they determine that activities constitute business activities.

(d) Safe Harbor

A partnership will be presumed to be a qualified investment partnership if, during the tax period in which the income is recognized, no less than 90 percent of the cost of the partnership's total assets consists of the following:

(1) Common stock of publicly traded corporations, including preferred or debt securities convertible into common stock; and preferred stock, including debt securities convertible into preferred stock;

(2) Bonds, debentures, and other debt securities such as certificates of deposit and collateralized securities available for sale or trade through public markets;

(3) Deposits and any other obligations of banks and other financial institutions regulated by the United States government, a state, or by any political subdivision or governmental agency thereof, and cash and cash equivalents, including foreign currencies;

(4) Corporate stock and bond index securities, future contracts, derivative securities, warrants or options on securities, and other similar financial securities and instruments available for sale or trade through public markets;

	(5)	Interests in partnerships or other pass-through entities but only if those partnerships or entities meet the requirements of this safe harbor;	
	(6)	Other similar or related financial or investments contracts, instruments, or securities; and	
	(7)	Office facilities and other tangible and intangible personal property reasonably necessary to carry on its investment activities, including accounts receivable.	
	The presumption provided here is intended to act as a safe harbor and does not limit the application of the general rule provided in Section (c) of this regulation. The presumption provided by this Section (d) can be rebutted if the [STATE TAX AGENCY] can show that the investment partnership lacks economic substance or was put into place to evade tax.		
(e)	Examples		
	General Assumptions: In each of the examples below, assume Smith is a nonresident partner that holds an interest in Partnership X which has offices and activities in this state.		
	(1) Simple Example: • Smith meets the criteria of Section (b) of this regulation. • X meets the safe harbor of Section (d) of this regulation. • X has dividends from corporate stock. The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, such dividends from investment in corporate stock recognized by an individual would be sourced to the individual's state of residence. [REFERENCE TO STATUTES AND REGULATIONS.] Therefore, Smith's distributive share of the dividend income of X is not sourced to this state.		

(2) Partnership X Meets General Criteria but not Safe Harbor:

- Smith meets the criteria of Section (b) of this regulation.
- X does not meet the safe harbor of Section (d) of this regulation, but otherwise meets the definition of a qualified investment partnership under Section (c).
- X has dividends from corporate stock.

The fact that X is not presumed to be a qualified investment partnership does not prevent it from being treated as one. The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, such dividends from corporate stock recognized by an individual would be sourced to the individual's state of residence. [REFERENCE TO STATUTES AND REGULATIONS.] Therefore, Smith's distributive share of the dividend income of X is not sourced to this state.

(3) Partnership X has Gain from Sale of Real Property in this State:

- Partner Smith owns an interest in Partnership X.
- Smith meets the criteria of Section (b) of this regulation.
- X does not meet the safe harbor of Section (d) of this regulation, but otherwise meets the definition of a qualified investment partnership under Section (c).
- X has a capital gain from the sale of real property in this state.

The fact that X is not presumed to be a qualified investment partnership does not prevent it from being treated as one. As such, the activities of X in this state do not determine how Smith's distributive share of the capital gain is sourced. Rather, under state statutes and regulations, such capital gains from real property in the state that are recognized by an individual would be sourced to this state. [REFERENCE TO STATUTES AND REGULATIONS.] Therefore, Smith's distributive share of the capital gains is sourced to this state.

If X were found not to meet the definition of a qualified investment partnership under Section (c), then X's activities in the state might affect the sourcing of the gain from the sale of real property. If the gain were determined to be part of X's unitary business, then the gain would be apportioned as part of X's business income using [REFERENCE TO STATE'S APPORTIONMENT RULES APPLIED TO PARTNERSHIPS]. If the gain were determined to be nonbusiness [OR NONAPPORTIONABLE] income of X, then the gain would be allocated under [REFERENCE TO STATE'S RULES FOR SOURCING NONBUSINESS INCOME].

(4) Partnership has in Distributive Share Income from Another Partnership:

- Smith meets the criteria of Section (b) of this regulation.
- X does not meet the safe harbor of Section (d) of this regulation, but otherwise meets the definition of a qualified investment partnership under Section (c).
- X has distributive share income from an interest in Partnership Y, doing business in this state.

The fact that X is not presumed to be a qualified investment partnership does not prevent it from being treated as one. The activities of X in this state do not determine how Smith's distributive share of the capital gain is sourced. Rather, under state statutes and regulations, such distributive share income recognized by an individual would be sourced to this state based on the activities of Partnership Y. [REFERENCE TO STATUTES AND REGULATIONS.] Therefore, Smith's distributive share of the income of Partnership Y, flowing through Partnership X, is sourced to this state based on the activities of Partnership Y.

	(5) Partnership X is a Qualified Investment Partnership but Smith is a Dealer: • Smith meets the criteria of Section (b) of this regulation. • X meets the safe harbor of Section (d) of this regulation. • Smith acts as a dealer in investments and has customers in this state. The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, Smith's investment in X would be considered part of the inventory of assets with respect to which Smith acts as a dealer. [REFERENCE TO STATUTES AND REGULATIONS.] Therefore, Smith's distributive share from X is sourced to this state as part of the income of Smith's business as a dealer in this state.	
	(6) Smith Uses Investment in Partnership X in Another Business: • Smith meets the criteria of Section (b) of this regulation. • X meets the safe harbor of Section (d) of this regulation. • Smith operates Business Y, a sole proprietorship, in this state. • Under state statutes and regulations, Smith's investment in X would be considered part of the business income of Business Y. [REFERENCE TO STATUTES AND REGULATIONS.] The activities of X in this state do not determine how Smith's distributive share of the dividends are sourced. Rather, under state statutes and regulations, the distributive share from X would be sourced to this state as part of the income of Business Y.	

	(7) Smith Participates in the Management of the Qualified Investment Partnership: • Smith is a minority partner but participates in the management of X and receives a carried interest (profits interest) for the services Smith performs. • X has dividends from corporate stock. Because Smith is engaging in the management of X, Smith's distributive share of income from X, including the share of dividends from corporate stock, is allocated and apportioned to this state based on the activities of X in this state.	
	(8) Smith Owns a Share of an S Corporation which Owns an Interest in Partnership X. Because the partner in this case, the S corporation, does not meet the criteria of Section (b) of this regulation, this regulation does not apply. Instead sourcing rules under [REFERENCE TO SOURCING OF S CORPORATION INCOME] would apply.	

APPENDIX – COMMENTS & RESPONSES

Note: Much of what is summarized in this appendix has also been discussed in the MTC work group calls and is covered in the MTC Revised White Paper on State Tax Sourcing of Partnership Income, available on the project page, here: https://mtc.gov/wp-content/uploads/2026/01/White-Paper-on-Sourcing-Partnership-Income-1-29-26.pdf.

The MTC received comments on the revised combined draft model provisions from the AICPA, the Eversheds Sutherland law firm, and the Energy Investment Council. The comments from the AICPA suggesting certain specific wording changes or clarifications, and the responses to those comments are summarized in a table at the end of this appendix.

Two issues generated more extensive comments from all three groups:

1. Partnership information reporting requirements, and
2. Use of the absolute value method to determine a partner's share of partnership factors when blending.

The comments about these two issues have also been discussed as part of the recent work group calls. In order to fully respond to these comments, additional context is needed. The comments are summarized here, along with that context, before setting out the responses.

Information Reporting Requirements

Part III of the draft model provisions sets out requirements for partnerships to report certain information to their partners that is necessary for direct and indirect partners to comply with their state tax reporting obligations and to also provide certain information to the state that will confirm this information.

Summary of Comments

The AICPA, in its comments, addresses two main issues with respect to information reporting requirements, and these comments were also echoed by the EIC.

- First, the AICPA requests that the provisions clarify and limit how partnerships may be required to "report direct or indirect partner information," asserting that the requirements provide that "partnerships must obtain and provide to the state tax agency certain partner level information for any state in which the partnership has a direct or indirect partner doing business in or resident in."

- Second, the AICPA's comments also include this statement:

> "The model provisions require a partnership to provide to the state tax agency 'any information' the agency deems necessary to verify the information reported to partners under Subpart A, as directed through regulations, forms, or instructions. This requirement is overly broad and effectively grants open-ended authority to the state tax agency to require additional information without clear parameters or limitations. In particular, the provision does not appear to contemplate how throwback sales should be determined in a partnership context."

The AICPA also references information related to specific state adjustments and the proper application of state throw-back rules as examples of information which a partnership would not know is necessary to provide for an indirect partner to comply with the tax law of a state where the partner is resident or doing business.

<u>Context & Response</u>

In responding to these comments, context is critical. This section first sets out that context and then provides a response to the comments, below.

<u>Important Context</u>

Partnerships are creatures of state law. Under this law, partners agree to act collectively and give the partnership certain rights to do so. But forming a partnership does not alleviate partners of their individual legal responsibilities. Rather, partnerships are required to maintain and provide necessary information so that the partners can comply with their individual legal obligations.[1] Certain information must legally be provided by all partnerships, and other information must be provided when requested by partners.[2] In this way, the law prevents partnerships from being used as a legal shield. And while these state partnership laws do not specifically address state tax information reporting requirements specifically, they allow for these requirements to be imposed under the state's tax law.

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[1] See for example the Uniform Law Commission Uniform Partnership Act-1997 (updated as of 2013), Sec. 408. Rights to Information of Partners and Persons Dissociated as Partner. available here: ttps://www.uniformlaws.org/viewdocument/final-act-98?CommunityKey=52456941-7883-47a5-91b6-d2f086d0bb44&tab=librarydocuments.

[2] Id.

When it comes to taxing partnership income, states generally conform to the federal pass-through system.[3] This federal system provides a number of taxpayer benefits. The income is taxed only once, when earned, and not again when distributed. Also, because the character of the tax items is determined at the partnership level, certain benefits, such as the treatment of capital gains, are maintained as that income flows through. This federal system also provides substantial flexibility to structuring partnerships. But for the system to function properly, information must be transmitted by partnerships to the taxpaying partners, whether direct or indirect.

Today, investors and businesses are forming larger, more complex partnerships than ever before. The creation of these complex structures with multiple tiers may be driven by diverse investment and other interests, and the structures may change over time. These structures may provide significant economic benefits, but they come with certain administrative costs. An important cost involves the need to transmit information through these complex structures in order to reach the ultimate partners and investors.

A partnership's direct and indirect partners and investors may be resident or doing business in states where the partnership has no activities. But the law would still require that these partners report and pay tax on their partnership income in accordance with that state's law. To the extent the state conforms to the federal substantive tax rules, this simplifies state tax reporting. But all states also require additional information to show that multistate income has been properly sourced. This information must be provided by the partnership.

The federal tax law delegates to the IRS the authority to require partnership information reporting using broad, general terms.[4] IRS regulations then provide that the specific information reporting requirements will have to be set out in much more detail in IRS forms and instructions.[5] Those forms and instructions are widely seen as becoming more detailed over time and as substantive rules change.[6] This adaptability is important. The federal information reporting requirements apply not only to the partnership that recognizes the tax items in the first place, but also to any upper-tier partnerships through which those items flow. Each partnership in the structure is, therefore, required to maintain and properly report information obtained from lower tiers.

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[3] See IRC Subchapter K to which most states conform.
[4] See IRC §6031.
[5] See Reg. §6031(a)-1.
[6] See IRS Form 1065 and Schedule K-1 and instructions.

Finally, it should be noted that federal and state tax related information is not the only information that must flow through these complex structures. Economic results must also be tracked and reported so that individual and corporate investors and other affiliated businesses can ensure that they have received the economic benefits to which they have agreed. And, under the federal pass-through system, the tax-related information generally tracks this same economic information.[7]

Response to Comments

Since receiving the AICPA comments, work group calls have made clear that the model information reporting requirements do not require that partnerships obtain information on the tax attributes of their partners or information identifying their indirect partners, or to report this information to the state. Here is what Subpart A of Part III provides:

> "A partnership shall provide **to its direct partners** the **information necessary for its direct and indirect partners or beneficial interest holders to properly compute and report their [STATE] tax**. Necessary information includes any information as described or provided for in regulations, forms, and instructions issued by the [STATE TAX AGENCY]."

As noted above, general state laws governing partnerships already require that the partnership must provide information necessary for partners to comply with the law. The provision above makes clear that, to the extent the partnership has tax information necessary for partners, whether direct or indirect, to comply with the state's tax law, the partnership must provide that tax-related information to its direct partners.

But we also understand that the primary concern behind these comments is whether partnerships can necessarily know that certain partners or indirect partners will need tax-related information in order to properly file in a state where the partnership itself has no activity. This kind of information pertains to things like specific state adjustments to federally-reported income and the application of state sourcing rules.

We agree that, in cases where a lower-tier partnership has no information that would indicate that a partner or indirect partner needs certain state tax information, those partners may have the responsibility to effectively request that information. States can facilitate this request by providing a list of information (e.g. state adjustments, whether the state has a receipts throw-back rule, etc.)

[7] See IRC §704(b).

that taxpayers can then provide to entities in which they hold a direct interest, and which would, in turn, be provided by that entity to any entities in which it holds interests, etc. To address this, Section E was included in Part III.

We also generally disagree with the AICPA's comment that the model requires partnerships to report any information to the state that it deems necessary—a requirement which they assert is overly broad without clear parameters or limitations. Subpart B of Part III states:

> A partnership shall provide to the [STATE TAX AGENCY] certain information as directed by the [STATE TAX AGENCY] necessary **to verify the information required to be reported to partners under Subpart A**, above and as provided in regulations, forms, and instructions issued by the [STATE TAX AGENCY].

Subpart C of Part III then goes on to list specific types of information that this may include.

This is similar to the approach to information reporting taken by the federal government—where statutes provide authority for the IRS to require information reporting by partnerships and the specific requirements are set out in regulations, forms, and instructions.

State information reporting requirements in the draft model provisions are directly tied to the pass-through system and substantive state tax rules. While this system and the differences in state tax rules may contribute to the administrative difficulties of information reporting, most of that difficulty is caused by complex, multi-tiered structures. If states were to limit information reporting requirements for these large complex structures, they could then easily be used to avoid state tax obligations.

Use of the Absolute Value Method

Part IV of the draft model provisions sets out the methods for sourcing partnership income and addresses tiered and corporate partners in particular. The default method for sourcing partnership income is to source that income applying state rules at the partnership level. As a result, when sourcing their distributive share, a tiered or corporate partner would simply replicate the sourcing determined at the partnership level.

However, in certain circumstances, fair apportionment may require that the tiered or corporate partner use the blending method—adding the distributive share to the partner's own apportionable income base and also adding a share of partnership apportionment factor components into the partner's apportionment formula used to apportion that base. To apply blending, the partner's share of partnership factor components must be determined.

<u>Distributive Share Method and Absolute Value Approach</u>

To determine the partner's share of partnership apportionment factor components for blending, the current version of the draft model provisions uses the following ratio:

> Partner's guaranteed payment and distributive share of partnership items (including the expense associated with guaranteed payments) from the partnership's unitary business using the absolute value method
>
> ———
>
> Total amount of all partner's guaranteed payments and distributive shares of partnership items (including expense associated with guaranteed payments) from the partnership's unitary business using the absolute value method.

This method will be referred to here as the "distributive share method." Because partnerships may make guaranteed payments, disproportionate special allocations, or mandatory or remedial allocations of items, this distributive share method can produce a negative ratio or one that exceeds 100%. To eliminate this problem and to better reflect the effect of the partnership income on the partner's own unitary income, the model also applies the absolute value approach when calculating that ratio.

Summary of Comments

All three groups submitting comments on the draft model provisions had comments on the use of the absolute value method. These comments were more detailed and there are common themes. Rather than simply reiterating the comments, the bullets below summarize these common themes.

- The comments set out a number of circumstances in which there may be allocations that do not correspond to a partner's share of capital, including:
    - Special allocations generally,
    - Use of preferred equity,
    - Mandatory (remedial) allocations, and
    - Allocations related to IRC § 743(b) adjustments.
- The comments criticize the absolute value approach, and presumably also the use of the distributive share method, on the basis that the approach:
    - Results in a "negative economic item" determining the share of partnership factors,
    - Does not reflect the partner's capital or ownership share, and
    - Does not reflect the specific factors (receipts or property) that might be more directly associated with certain specially allocated items.
- The comments suggest that rather than mandating the absolute value approach:
    - The rules should allow taxpayers the flexibility to use any other reasonable methods; or
    - The absolute value approach should be used only to prevent abuse.
- The comments argue that the method may not be workable in large complex structures.

<u>Context & Response</u>

As with the information reporting comments, there is important context with respect to understanding the comments on the use of the absolute value approach. This section first sets out that context and then provides a response to the comments, below.

Important Context

Certain information is necessary to fully understand and respond to some of the comments made concerning the absolute value method.

Importance of state's choice of formulary apportionment versus specific assignment –

Federal and international business income sourcing rules generally use an approach to sourcing income that we will refer to as specific assignment. Under specific assignment, different types of income will be sourced to a location based on the underlying activity or associated transaction. Certain direct expenses are similarly sourced and then indirect expenses are categorized and apportioned based on the sourcing of the gross income.

States do not use this specific assignment approach when sourcing apportionable multistate or multinational income. Rather, they apportion net business income using a formula of certain factors. That formula is typically composed of the amounts of receipts, tangible and real property, and/or payroll in the state versus the amounts that the business has everywhere. A single apportionment formula can be applied to the net income of a unitary business—including a business composed of separate entities. Most states today use a single-sales or receipts factor formula. Using formulary apportionment to source net income means that all tax items (receipts, gains, expenses, losses, etc.) that go into that net apportionable income amount are effectively apportioned the same way.

Assume State X has a single-receipts factor formula and Corp has 50% of its receipts in State X. Corp would not only apportion 50% of its gross receipts from sales to State X, it would also apportion 50% of its returns and allowances, apportionable interest income, payroll expense, interest expense, administrative and overhead services costs, and depreciation to State X. The fact that some or all of the interest expense, overhead costs, or depreciation expense have no other connection to State X or to the factors used in the State X apportionment formula does not matter. Such is formulary apportionment.

Using formulary apportionment versus specific assignment may lead to very different sourcing results. Despite these differences, formulary apportionment has been found to be constitutional. Nor can it be said that one method is more "accurate." See *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

States generally use formulary apportionment for business income of partnerships, S corporations, and proprietorships as well as corporations. This creates parity in how states source and tax multistate business income. That said, we are aware that in some cases, partnerships holding particular income-producing assets (e.g., real property) have used the location of those assets to source the receipts generated, assigning direct expenses to that same location and apportioning overhead expenses in an approach that is similar to specific assignment. In some cases, the result may not be significantly different than if that partnership used formulary apportionment to source the net income.

<u>Use of blending and its relationship to factor representation</u> –

Most states require related corporations engaged in a unitary business to combine their factors and their income when applying formulary apportionment. For example, assume two corporations—Parent and Sub—engage in a unitary business. Parent provides certain services to Sub and Sub sells intangible products to its customers. In combining the income and receipts factors of Parent and Sub, any intercompany charges will be eliminated. The combined factors of both entities would then be used to apportion the combined net income. This means that the factors of Parent will affect the sourcing of Sub's income, and vice versa.

Blending is a method sometimes used for apportioning partnership income. When using blending, rather than sourcing partnership income based on the entity's application of sourcing rules, the partner will include its distributive share and guaranteed payments from the partnership in its apportionable base, offsetting the related income and expense from any partner / partnership transactions, and will also include a share of the partnership's factor components (receipts, property or payroll amounts) in its apportionment formula.

Under the draft model provisions, blending will only be used by a direct partner that is engaged in business. Blending will also only be used when that partner and partnership have a sufficient unitary relationship. So, blending will not apply to the vast majority of partners.

And, as discussed in the white paper (see Note at the beginning of this appendix), and in the work group calls, blending may be necessary to provide the kind of factor representation needed for fair apportionment. That is, to the extent a partner's net apportionable income is affected by its share of partnership items, the inclusion of partnership factors may be necessary to fairly represent the source of that blended partner/partnership income. The question blending poses is how to compute the share of partnership factors to include in the partner's apportionment formula.

How special allocations and guaranteed payments affect shares of partnership income –

But before addressing how the share of partnership factors may be computed, it is important to understand guaranteed payments and so-called "special allocations," or mandatory or remedial allocations. In addition to the MTC white paper referenced in the Note above, the MTC also published a separate white paper on guaranteed payments, focusing on the sourcing of guaranteed payments for services, here: https://mtc.gov/wp-content/uploads/2023/12/White-Paper-on-Guaranteed-Payments-Final-Version-October-12-2023-Updated-12-11-23.pdf.

Guaranteed payments –

Under IRC § 707(c), a partner may receive a payment for acting in the capacity of a partner (rather than in a separate capacity under § 707(a)) for performing services for or providing capital to the partnership. The partnership treats the guaranteed payment as deductible or capitalizable expense (depending on the type of service) and the partner treats it as ordinary income. So, in this respect, the partner's treatment of the guaranteed payment differs from the treatment of other distributive share items whose character is attributed to the partner. But the partner will also receive an allocation of that partner's share of the expense associated with the guaranteed payment. And, in other respects, the guaranteed payment is treated as partnership distributive share.[8]

Special allocations –

Under IRC Subchapter K, partnerships are not required to make allocations of net distributive share income to partners based on the partner's capital ownership. Nor are they required to allocate to a partner the same share of all items of partnership income, expense, gain, or loss. Rather, partners can agree to what are referred to as special allocations. See IRC § 704(b).

[8] See Reg. 1.701-1.

Assume Partnership has two partners X and Y. When the partnership is formed, X and Y share partnership capital 50/50. They can agree to share partnership income in a host of different ways, including, for illustration purposes, the following scenarios:

1. Sharing all items 50/50 (no special allocations)
2. Sharing all items 80/20 (referred to here as "proportionate special allocations")
3. Sharing certain items 50/50 and other items 80/20 (referred to here as "disproportionate special allocations")

One important thing to know about special allocations is that they effectively change the partner's tax capital account over time. (The same is not true of guaranteed payments.) Assume that X and Y choose option 2 above, where X receives 80% of partnership income and items even though X only holds 50% of the partnership's initial capital. If the partnership has taxable income, that 80% allocation of income will be credited to X's capital account, increasing X's share of capital relative to Y's share of capital. If the partnership has a tax loss, the 80% allocation of that loss will be subtracted from X's capital account, decreasing it relative to Y's share of capital.

Another thing to know is that partners can also agree that these allocations of partnership income and items will change over time or from year to year. For example, some partnerships use targeted allocations of partnership income (sometimes referred to as preferred allocations) in order to provide certain partners a targeted amount capital which is designed to give them a certain return on their initial investments. The amount and share of these targeted allocations each year may depend on the partnership results in that year.

In addition, the share of partnership items allocated to a partner may be affected by other rules under Subchapter K. For example, when a partner has contributed property with a different fair market value than the partner's own basis (IRC § 704(c)) that partner may be allocated the built-in gain recognized when the partnership sells that asset. Or, when a partner buys a partnership interest for an amount that is different than the selling-partner's capital, that partner may be allocated additional depreciation associated with an adjustment to that partner's inside basis. The former will affect the partner's tax capital account, the latter will not.

Possible different approaches for computing a partner's share of partnership factors –

Returning to how a partner's share of factors may be determined when using blended apportionment—the methods most often discussed are:

1. Specific association – Associating the share of the particular factors with the partnership items allocated to the partners (specific association method);

2. Capital – Using the partner's share of capital (capital share method), or

3. Distributive Share – Using a ratio based on the partner's distributive share (distributive share method).

Why the specific association method is inappropriate –

As discussed above, states have chosen to source multistate income not by using the international sourcing approach—specifically assigning the receipts from each activity and transaction to certain locations, associating direct expenses with those receipts, and then apportioning indirect expenses—but, instead, by apportioning net income. The apportionment formula is used to source not just items with which the factors of that formula might be directly connected (e.g., receipts, depreciation, and payroll expense) but all items that go into the calculation of net apportionable income of the same unitary business.

The specific association method of determining the sourcing of a partner's share of partnership items would appear to abandon this very foundational premise of formulary apportionment and require that, when blending, the partner look to specific types of income or partnership items when determining the associated partnership factor components to include in that partner's apportionment formula.

And given that blending would only be used where the partner itself has income earned from a business which has a sufficient unitary relationship with the partnership's business, this would mean that the apportionment factors used to apportion the partnership income included in the partner's apportionable base would be determined and included in the formula using a different basis than the partner's own apportionment factors.

Evaluating the capital share and distributive share approaches –

This leaves two general methods to consider—the capital share method and the distributive share method. Where there are guaranteed payments, mandatory (or remedial) allocations, or proportionate or disproportionate special allocations, the share of factors computed under the capital share and distributive share methods will differ.

So, under Scenario 2 above, if X uses blending, the capital share method results in X including 50% of the partnership factor components whereas using the distributive share method results in X including 80% of those components. But note, again, because special allocations of partnership income will affect the partner's tax capital, the difference may also change over time. Assume, again, that X and Y adopt option 2 for sharing partnership income giving X an 80% share. If the partnership has income each year for a period of years, all things being equal, X's share of capital will grow until it reaches and, perhaps exceeds, this 80/20 ratio.

The results will also differ where there are guaranteed payments. Again, take X and Y, the 50/50 partners described above. Assume the partners agree to share partnership income and items 50/50 but that X will receive a guaranteed payment of $100,000 for performing services for the partnership. Now assume that Partnership has net distributive share income of $200,000 before the guaranteed payment. X will receive the $100,000 guaranteed payment which will also reduce the partnership's net distributive share income to $100,000 which will be split 50/50 between the partners. So X will receive a total of $150,000 of distributive share and guaranteed payments and Y will receive $50,000. So, if X uses blending, the capital share method results in X including 50% of the partnership factors whereas using the distributive share method results in X including 75% (without the absolute value method, discussed below).

Why the distributive share method is recommended –

The white paper (referenced in the Note at the beginning of this appendix) recommends the use of the distributive share method. The most important reason for this is because the apportionment formula is meant to source ***income, not capital***. Take an extreme example. Assume that two partners, X and Y, have initial capital in a partnership that they share 60/40, and that X's business and the business of the partnership have a sufficient unitary relationship. But they also agree Y will receive 100% of the income generated in Year 1. Why should X include any share of the partnership's factors in its apportionment formula when its distributive share of partnership income in Year 1 is 0%? The argument that using the share of capital is more fair appears to disregard the fact that capital does not determine a partner's share of the *partnership's income* and it is *income* that is being apportioned.

There does not seem to be any basis, therefore, to argue that the distributive share method does not fairly reflect the factors associated with the income included in the partner's blended income. But the use of the distributive share method is complicated by the fact that computing the share will lead to anomalous results when there are certain special, mandatory, or remedial allocations or guaranteed payments resulting in a disproportionate amount of some partnership income or items being allocated to the partner. To address this, the draft model rules apply the absolute value approach.

<u>How the absolute value approach works</u> –

Where there are no disproportionate special allocations, mandatory allocations, or guaranteed payments, the use of the absolute value method makes no difference in computing the partner's share of factor components under the distributive share method. So, for example, assume two partners have a 50/50 capital ownership share. Whether they agree to share all partnership items 50/50 or 80/20, the use of the absolute value approach will not make a difference in the share of factors determined using the distributive share method.

When there are disproportionate special allocations, mandatory allocations, or guaranteed payments, the result will be different when using the distributive share method with versus without the absolute value approach.

For example, assume X and Y own 50/50 shares of partnership capital and Y's own business has a sufficient unitary relationship with the partnership's business so that Y will use blended apportionment. Also assume that the partners agree that Y will receive 80% of partnership receipts and only 20% of partnership expenses. Now assume that partnership receipts are $100,000 and partnership expenses are $80,000—so that Y receives $80,000 of receipts and $16,000 of expenses.

- Using the distributive share method without the absolute value approach:
    - Y's net distributive share of $64,000 ÷
      The partnership's total net distributive share of $20,000
      = 320%

- Using the distributive share method with the absolute value approach:
    - Y’s absolute value of receipts and expenses of $96,000 ÷
      The partnership’s absolute value of receipts and expense of $180,000
      = 53%

<u>Response to Comments</u>

This section provides a response to the comments as summarized, drawing on the context set out above.

First, we agree that there are a number of circumstances in which there may be allocations that do not correspond to a partner’s share of capital, including:

- Special allocations generally;
- Use of preferred equity,
- Mandatory (remedial) allocations, and
- Allocations related to IRC § 743(b) adjustments.

Also, as the context above discusses, guaranteed payments can also be made to partners which are not in accordance with that partner’s share of capital. The fact that these allocations and guaranteed payments result in effects on the partner’s income that do not correspond to the partner’s ownership share is the main reason why, when blending, the capital share method is an inappropriate method for determining the partner’s share of partnership factors.

In addition, the following criticisms of the distributive share method using the absolute value approach do not appear well-founded for the reasons given below. But first, the following essential elements of the blended apportionment approach should be kept in mind.

- First, as with the state sourcing rules generally, blended apportionment relies on formulary apportionment, not specific assignment of items of income and expense.

- Second, blended apportionment will only apply when the partnership’s own business has a sufficient unitary relationship with the partnership’s business so that the partner’s apportionable income would include its partnership distributive share and its apportionment formula would include a share of partnership factors.

<u>Criticism</u>:

The distributive share method results in a "negative economic item" determining the share of partnership factors.

<u>Response</u>:

What the comments refer to as "negative economic items" have as much effect on partnership net income as any positive economic items. Indeed, as noted in the context above, states use apportionment factors to apportion both negative and positive items that make up net income. Therefore, the fact that a partner's share of partnership expenses may be much greater than its share of partnership receipts does not counsel against using the absolute value approach. Rather, it is exactly that effect of these disproportionate allocations on the partner's income that is important when determining the partner's share of related partnership factors.

The comments also contrast the "magnitude" of items with the partner's "actual net income" from the partnership. However, "net income" is simply shorthand for net income *or loss*. After all, it is not the case that multistate businesses that have expense in excess of revenue—that is, a loss—don't apportion that loss or don't use the normal apportionment factors when doing so. And if that business apportions the loss on the basis of a receipts factor, it is, effectively using receipts sourced to the state (or "positive input" as the comments would refer to it) as a basis for assigning expenses (or "negative economic items").

For example, assume that in Year 1 a start-up partnership business has deductible expenses of $1 million incurred from activity entirely in State Y and only one customer, in State X, from whom it has received $100,000 in receipts. Also assume both states use a single receipts-factor apportionment formula and would source the partnership receipts to State X. If the partnership apportions its $900,000 net loss at the entity level, it will apportion it entirely to State X. That is, all of the deductions (which are included in the apportionable net loss) will be sourced to State X.

Now assume that the partnership has a 50% partner to whom the partnership has allocated 100% of the expense deductions. If that partner does not use blending, it would simply source its distributive share of those deductions entirely to State X and would include them as a reduction to any other income it might separately source to State X. That is, the deductions would be sourced by the partnership using the partnership's own apportionment formula applied to those items of expense, and that would determine where those deductions are sourced for the partner as well.

But if the partner's own business has a sufficient unitary relationship with the partnership's business so that the partner would use blending, then the partner would include its 100% allocation of the partnership's deductions in the partner's apportionable base, combining and offsetting those deductions against the partner's other apportionable income before that blended base is then apportioned. There is no reason why, in this case, the location of the expense rather than the location of the receipts should determine how those deductions are sourced, or why the partner's share of partnership receipts should not be affected by the magnitude of the partner's share of partnership deductions.

Criticism:

The method does not reflect the partner's capital or ownership share.

Response:

As discussed in the context above, apportionment is not applied to capital or the taxation of capital, it is applied to income. Nor are partners required to share partnership income and items in the same proportions as their share of partnership capital. Therefore, the fact that the method does not reflect the partner's capital is not a sound criticism of the distributive share method or the absolute value approach.

Criticism:

The method does not reflect the factors that might be directly associated with certain specially allocated items.

Response:

As discussed in the context above, formulary apportionment is regularly used to source items of income and expense that are not directly associated with the particular factors included in the apportionment formula. This criticism implies that the proper method for sourcing partnership income is a kind of specific assignment approach, as used by the international tax system, rather than formulary apportionment. To take this approach for partnership income would differentiate how that income is sourced when compared to similar income of C corporations or proprietorships.

Finally, the comments suggest that rather than mandating the use of the distributive share method using the absolute value approach, the rules should allow taxpayers the flexibility to use any other reasonable methods or should only apply the absolute value approach to prevent abuse. The comments also argue that the distributive share method using the absolute value approach may not be workable in large complex structures.

To be clear, the application of blending and the use of the distributive share method using the absolute value approach would be done by direct partners that have a sufficient unitary relationship with the partnership. Presumably, in that case, the partnership and partner have sufficient information and can share that information as necessary to properly apply the method.

As covered in the context section above, the other possible methods—the specific association and capital share methods—have been analyzed and discussed, both in the MTC white paper (see reference in the Note above) and in work group calls. Indeed, the comments appear to raise an additional problem with the capital share method, which is that a partner's tax capital may change over the course of the year, raising questions as to the point in time when that share would be applied to the partnership's factors. Based on this analysis, neither method appears reasonable. Rather, there are significant problems with these other methods.

Nor is an open-ended provision allowing "any reasonable methods" likely to be administrable given that there appears to be no standard for when the distributive share method is unreasonable or what makes other methods more reasonable. Simply allowing other methods to be used for sourcing partnership income would undermine parity in sourcing business income generally. Nor can states simply allow any other reasonable method without creating significant complexity and uncertainty—two things which we agree should be avoided when possible. Finally, there may be circumstances in which the state would use its general authority to grant equitable apportionment where there are genuine problems with the use of the distributive share method using the absolute value approach.

As for the absolute value approach being used only when there is abuse, this is not the focus of blending, the use of the distributive share method, or the absolute value approach. The focus is to provide factor representation for the income flowing through the partnership and included in the partner's apportionable income.

Responses to AICPA Comments – May 21, 2026

The comments and responses are summarized by general category and the type of response.

Clarifications and Minor Wording Changes	
Comments: **Minor wording changes.**	The AICPA made a number of comments recommending clarifications or minor wording changes (not separately summarized here).
Response:	Unless otherwise noted, those changes (or similar modifications) have been made.
Comments on Applicability	
Comment: **Include other passthrough entities in definition of indirect partner.**	Change the definition of an indirect partner to: "An owner of a pass-through entity that, itself, owns an interest in another pass-through entity."
Response:	Because these provisions are intended to address entities taxed under Subchapter K, we need to be careful how other pass-throughs are included so that states adopting these rules can understand how they may affect other types of pass-throughs. Rather than simply changing the definition of "indirect partner," changes were made to the provisions to add the terms "other pass-through entity" and "beneficial interest holder."
Comment: **Exclude entities paying PTE tax from definition of partnership.**	Add to the definition of "partnership" – "Entities that have validly elected under a state's so-called pass-through entity tax (PTET) law to become taxable by the state at the entity level, are not considered partnerships for this purpose, and are not subject to this act nor are their owners in their capacity as such," . . .
Response:	We cannot exclude PTEs from being treated as partnerships subject to the provisions here. States that allow taxes to be paid at the entity level also generally require the partners to continue to determine their share of partnership income, and source it properly, in order to determine their tax and to obtain the credit for taxes paid at the entity level, as well as credits for taxes paid by residents to other states.

Comments on Blending – When and How	
Comment: **Application of the Unitary Business Principle**	The AICPA asked that the model "apply the unitary business principle to partnership income sourcing" and recommends that it be confirmed in both the MTC white paper and commentary to the model provisions that the unitary business principle (UBP) applies to partnership income sourcing. (See also specific recommendation as to the language to be substituted, discussed below.)
Response:	Certain clarifying changes to the language were made. But note—as the work group has discussed, the application of the UBP to the state sourcing of distributive share income attributed by a partnership to a partner has never been addressed by the U.S. Supreme Court and there is uncertainty both because of the attribution principle and important differences between corporations and partnerships. Also, the model does set out criteria for when partners and partnerships will have a sufficient unitary relationship. These criteria are similar to the long-standing criteria applied to entities as well as businesses and their assets.
Comment: **Include reference to *Rawat* decision.**	The AICPA asked that the model Include the decision in *Rawat v. Comm'r* with section 751 in the model provision regarding the appropriate law for determining the character of a partner's gain on disposition of their interest in the partnership.
Response:	The model provisions do not address the sourcing of a partner's gain from the sale of a partnership interest. Therefore, this recommendation would be inappropriate.
Comment: **Specify that corporate sourcing rules are used.**	Clarify the applicable sourcing rules for partnership income. The comment notes: "Many states apply corporate sourcing rules when determining the sourcing of partnership income, even when the partners are individuals, recognizing that partnerships frequently operate as business entities rather than pass-throughs of passive investment income. Explicitly identifying the applicable sourcing regime as the corporate sourcing rules would promote uniformity, reduce the risk of inconsistent application across states, and simplify compliance for partnerships responsible for computing nonresident and composite tax. This approach illustrates the importance of clear statutory rules, along with a corresponding repeal of inconsistent sourcing rules in the existing state statutes and/or regulations."

Response:	This comment appears addressed to a small minority of states or issues where there is a substantial difference in how individuals and corporations would source business income. It appears that the AICPA is correct in asserting that it would increase uniformity and consistency, including consistency in the treatment of entity-level taxes, for states to apply the same sourcing rules (presumably those that would apply to the income of corporations). Therefore, we have included a drafter's note in Part III to this effect.
Comment: **Avoid duplicative inclusion of guaranteed payments.**	"Sourcing of Guaranteed Payments for Services and Additional Credit for Taxes Paid to Other States" (Page 15) 1. Modify "Part I: State Sourcing and Taxation of Certain Guaranteed Payments" A. Avoid double counting of guaranteed payments. The model provisions do not specifically address the risk of double counting guaranteed payments, an omission that can lead to a common and significant sourcing error. Without explicit guidance, guaranteed payments may be inadvertently included both in the partnership's apportionable business income and again as separately sourced income to the partner, resulting in duplicative treatment of the same income. Recommendation The AICPA recommends that the model provisions include explicit language addressing the sourcing of guaranteed payments to avoid double counting and taxing of guaranteed payments. Guaranteed payments should be excluded from ordinary business income before distributive shares are determined, ensuring that the same income is not included both in the partnership's apportioned business income and again as a separately sourced payment. The guaranteed payments can then be sourced independently using the partnership's apportionment factor.
Response:	The special rule for sourcing guaranteed payments set out in the draft model rules addresses the sourcing of guaranteed payments for services to individuals and is intended to bring uniformity to an area where states use two different rules. It does not appear that the approach recommended in the model would lead to double-counting of guaranteed payments. It appears that this issue is raised in the context of PTE filing, otherwise, it would not be possible for the guaranteed payment to be "included both in the partnership's apportionable business income and again separately sourced income to the partner." We agree that this could happen under the PTE context. But the provision here is not directed at PTE tax reporting, but at the reporting of tax on a pass-through basis.

	Nevertheless, we can add a drafter's note to the section to make the point that what the partner would do is take the partnership's apportionment formula and apply that formula to both the partner's distributive share income and the partner's guaranteed payments. There is a separate, but related need to clarify the sourcing rules for tiered and corporate partners, however. We have added language there to address the treatment of guaranteed payments.